



# Oklahoma Economic Report™

News and analysis of Oklahoma's economy

A publication of the Office of the State Treasurer • Treasurer Ken Miller, Ph.D.

## Pension fees and earnings

For several years following the last recession, public pensions – including Oklahoma's seven pension plans – experienced very strong investment returns. Investment returns immediately following the largest downturn in the nation's economy since the Great Depression were strong, but such earnings came back down to Earth last year.

The contrast is rather stark, even though Oklahoma's pension plans performed above the national average. During FY-14, Oklahoma's pensions generated returns of 19.9 percent, but during FY-15 those returns shrank to 3.6 percent.

During good times and bad, the funds pay millions to investment managers and consultants. Really, it's the cost of doing business, but during the good times little attention is paid to those fees. It's when returns go down and money is tight, that there's a stronger focus on the millions paid to manage the investments.

While there are various ways to save on those fees, including using passive management with index funds instead of active management and packaging the funds to gain economies of scale, an analysis of the fees paid by Oklahoma's pension plans shows little direct relationship between the fees paid and the performance of investments.

### Oklahoma plans

An analysis of fees paid by the state's public pension plans during the 2014 calendar year conducted by New England Pension Consultants (NEPC), consultant to the Oklahoma State Pension Commission, was published in August.

It shows fees, including those paid to investment managers and consultants, averaged 31 basis points (bps) and totaled \$86.9 million. There are 100 bps in one percent.

Across the seven plans in 2014, the fees ranged from a high of 55 bps for the Firefighters and Police systems to a low of 4 bps for the Judges system.

The largest fund, Teachers, paid 37 bps, while the second largest, Public Employees, paid 8 bps. The difference

in fees between Teachers and Public Employees can best be explained by the fact that Teachers has 5.5 percent of its funds under passive management, while Public

Employees has 44.3 percent invested in the same, low-fee manner.

The NEPC report shows fees increased by 5 bps or \$21.7 million compared to the 2013 calendar year. During 2013, fees ranged from a high of 61 bps for Police to a low of 5 bps for Judges. Teachers paid 27 bps and Public Employees paid 9 bps during 2013.

Of the seven systems, fees increased for four and decreased for three. The largest decrease in fees was for Police, down by 6 bps. Steven Snyder, executive director of the system, attributed the fee reductions to two factors: Many of the plan's fees are tied to performance, so as returns dropped, so did fees;

**“Times like these provide an opportunity to examine whether public pension plans are operating as efficiently as possible.”**

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## Treasurer's Commentary

By Ken Miller, Ph.D.

### Stay the course with TSET

In 1998, Oklahoma joined with 45 other states to negotiate a Master Settlement Agreement (“MSA”) with the tobacco industry to recover state funds lost to treating smoking-related illness. The four other states, Florida, Minnesota, Texas, and Mississippi, had separately settled their tobacco cases. Thanks to the MSA, the tobacco industry is estimated to pay Oklahoma about \$2 billion over the first 25 years of the settlement. Thanks to the efforts of forward-thinking statesmen, the people of Oklahoma were provided a ballot opportunity to determine how best to use that windfall for the benefit of our state.

In pitching State Question 692, Attorney General Drew Edmondson and Treasurer Robert Butkin, co-chairs of the committee to promote passage of the measure, gave voters valuable information to consider. Media outlets quoted Edmondson promising that with passage of the ballot question, “no future legislature or governor will be able to raid the trust fund. It will be a legacy for many, many generations to come.” Butkin stressed financial prudence by saying, “These payments may fluctuate up or down over the years. It would be reckless to build these into the budgets of state agencies under these circumstances. If we save and

invest the principle as it comes in, and only spend the interest, it will provide a steady revenue stream for Oklahoma.”

With a win margin of 69 percent, the Tobacco Settlement Endowment Trust Fund (TSET) was established and Oklahoma’s share of the MSA was constitutionally protected by a vote of the people on November 7, 2000.

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**“It would be reckless to build these payments into the budgets of state agencies.”**

**– Treasurer Robert Butkin**

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Oklahoma’s Constitution was amended to place a portion of each year’s tobacco settlement payments into an endowment trust fund whereby investment decisions would be made by a five-member board and spending decisions made by a separate seven-member board. With the corpus of the fund protected, investment earnings must be directed into the following areas:

1. Clinical and basic research and treatment efforts to prevent and



combat cancer and other tobacco-related diseases.

2. Tobacco prevention and cessation programs.
3. Programs designed to aid the health of Oklahomans or to enhance the provision of health care services to Oklahomans.
4. Programs designed to improve the health and quality of life of children.
5. Programs designed to enhance the health and well-being of senior adults.

TSET is performing exactly as advertised to voters and has become a model of fiscal conservatism for other states that have already blown their settlement funds. Last month, more than \$42.8 million was certified and made available to fund its constitutional mandate. It is not a surprise that the fund now has a balance near \$1 billion. Nor is it a surprise that politicians would like to control it.

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## Commentary

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Citizens are familiar with the “Tobacco Stops With Me” campaign that highlights the dangers of secondhand smoke, but fewer are familiar with the tens of millions spent on medical research and clinical trials at the OU Stephenson Cancer Center and the Oklahoma Center for Adult Stem Cell Research. Of note is that clinical research and treatment are listed as the first spending mandate in the state constitution. Prevention and cessation are listed second.

The last decade, smoking prevalence in Oklahoma decreased from 28.7

percent in 2001 to 23.3 percent in 2012. Oklahoma improves its rank from 47th to 39th among states for the percent of adults who smoke. Certainly, this has increased our citizens’ quality of life and reduced state spending on treating tobacco-related illness. While many would argue smoking prevention efforts have a point of diminishing returns, Oklahoma’s adult smoking rate still remains above the national average. Nonetheless, far fewer would argue that Oklahoma is investing enough in medical research and health care access to have reached such a point.

Few government programs ever deliver to citizens exactly as advertised. But TSET has done just that. The five health-related areas defined in the spending mandate are deserving and sufficiently broad to allow critical investment and board discretion based on evolving needs and outcomes. The recent announcement of a TSET grant to fund up to 118 OSU osteopathic physician residents in rural hospitals across the state is an excellent example that didn’t require a constitutional change. Oklahomans should stay the course with TSET.

## Fees

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and, Police negotiated a contract with a new manager for Large Cap Core investments, which cut those fees in half.

While combined fees for the seven plans increased over the year, returns dropped considerably across the board during the calendar year.

Teachers’ returns in 2013 were 24 percent, compared to 8.1 percent in 2014. Public Employees returns fell from 16.6 percent to 7.3 percent during the same time, and Firefighters went from 21.3 percent to 6.9 percent.

Details for fees and investment returns for each of Oklahoma’s public pensions

can be found on the charts on page 4.

### National perspective

Nationally, public pensions earned average investment returns of between 3.2 and 3.4 percent during FY-15. Callan Associates, Inc. reports earnings of 3.2 percent for public plans with assets of more than \$1 billion, and The Wilshire Trust Universe Comparison Service reports earnings of 3.4 percent for public plans with more than \$5 billion in assets.

That compares to gross composite returns of 3.6 percent for Oklahoma’s plans with a total value of \$28.8 billion during FY-15.

With a newfound focus on the fees paid to gain those returns, some public pension fund trustees are asking the Securities and Exchange Commission (SEC) to require fund managers provide more transparency and more frequent reporting on fees and expenses. On July 22, a coalition of 13 state and municipal treasurers and comptrollers sent a letter to the SEC asking for increased transparency.

The National Association of State Treasurers (NAST) is currently drafting a statement requesting increased disclosure of fees associated with one particular type of investment –

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## Fees

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private equity, which is composed of investments made directly into private companies that are not listed on a public exchange.

Some members of NAST are concerned that while private equity firms usually do disclose fees, they are often reported so deep in partnership agreements and financial reports that it becomes cumbersome for public funds to identify the full breadth of costs. Private equity plays a significant and growing role in public fund investments.

### Active vs. passive management

It's a long-standing debate – whether active or passive management of pension investments is the best policy – and it isn't going to be settled anytime soon.

Typically, higher fees are associated

with active investment, while lower fees are found with pension plans that use passive management. As noted earlier, Oklahoma's two largest systems employ very different investment strategies.

In FY-14, Teachers, with its active management strategy, ranked in the top one percentile of public pension fund performance. By contrast, Public Employees has paid much lower fees but has experienced respectable investment returns among its peers, just not to the level of Teachers.

A July 2015 report from the Maryland Public Policy Institute examined the correlation of pension fees with returns and found that, at least for the funds it examined, those with the highest fees underperformed on average those funds with the lowest fees.

Other market observers, however, argue

for the value added through active management. When comparing active to passive management, timing is an important factor. While it would be great if active managers outperformed passive management every year, such an expectation is unrealistic.

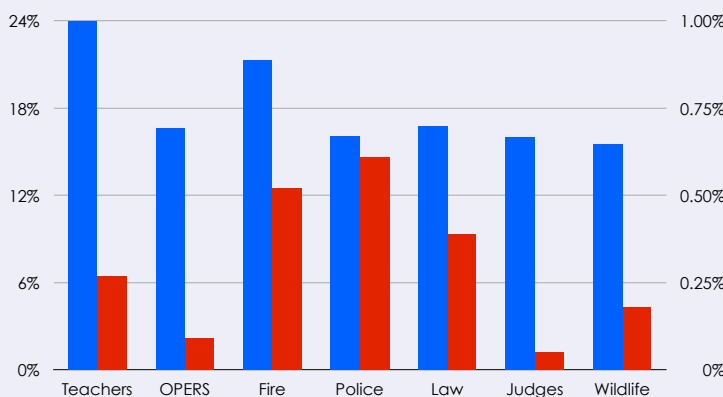
Supporters of active management argue it is best to use a full market cycle when comparing performance. That way, both an up and a down phase are included. To limit an evaluation period to a short-term time frame would be akin to expecting a batter to get a hit with every at bat and basing the final judgement on a small, 10-game sample size.

Over a long-term time horizon, they claim the record supports using active managers to gain better investment results.

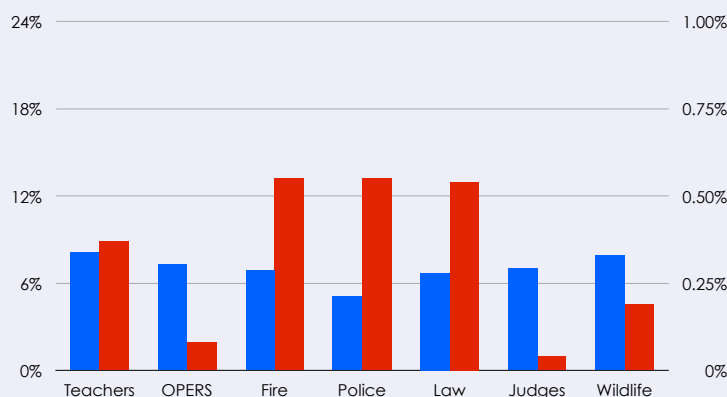
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### Oklahoma Pension Investment Returns vs. Investment Fees

#### 2013 – Calendar Year



#### 2014 – Calendar Year



Source: NEPC fee analysis, August 2015. Total fees include investment manager and investment consultant fees





## Fees

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### Going forward

When pension funds are earning record returns, there is little concern about fees being paid to those who manage the investments. But during years of nominal returns, fees can seem outsized. Public pensions invest for the long term and can weather the down years so long as there are some strong years to balance them out.

One year does not a trend make and one year of poor returns is no cause for panic, and management fees have limited impact on returns.

However, times like these provide an opportunity to examine whether public pension plans are operating as efficiently as possible to keep overhead low so more funds can be directed to paying benefits.

### Learn more

#### [Pension Fee Analysis](#)

([www.ok.gov/treasurer/documents/OK\\_Pensions\\_Fee\\_Analysis\\_Aug-15.pdf](http://www.ok.gov/treasurer/documents/OK_Pensions_Fee_Analysis_Aug-15.pdf))

#### [Pension Investment Report](#)

([www.ok.gov/treasurer/documents/OK\\_Pensions\\_Invest\\_Aug-15.pdf](http://www.ok.gov/treasurer/documents/OK_Pensions_Invest_Aug-15.pdf))

## National Institute of Public Finance hailed as success

More than 200 attendees, including 16 state treasurers and representatives of 26 states, attended the 2015 National Institute of Public Finance (NIPF) at Pepperdine University in late July

working through an intensive curriculum providing insight into current public finance issues.

Miller served as co-chair of the NIPF through his position as secretary-

treasurer of the National Association of State Treasurers (NAST) and chair of the NAST educational foundation.

On the opening day, July 26, Miller and co-chair Janet Cowell, state treasurer of North Carolina, conducted an interview with former U.S. Treasury Secretary Timothy Geithner, who discussed his experiences working in Washington and serving as President and CEO of the New York Federal Reserve during the Great Recession.

Miller said the institute helped treasury professionals be better equipped to serve their constituencies in an ever-changing financial environment.

“Operating the state treasuries of the nation is becoming more complex and challenging,” he said. “The program helped treasury professionals hone their skills, share ideas and learn best practices for safeguarding the people’s money.”

The NIPF was relaunched this year after a four-year hiatus. The program was redesigned to better meet the needs of state treasurers and their staffs.



Former U.S. Treasury Secretary Timothy Geithner responds to questions from Treasurer Miller and North Carolina Treasurer Janet Cowell during the 2015 National Institute of Public Finance at Pepperdine University on July 26. (Photo: Ron Hall Photography)



## Monthly Gross Receipts & General Revenue compared

July Gross Receipts to the Treasury totalled \$942.23 million, while the General Revenue Fund (GRF), as reported by the Office of Management and Enterprise Services, received \$418 million, or 44.4% of the total.

The GRF received between 35.7% and 53.6% of monthly gross receipts during the past 12 months.

From July gross receipts, the GRF received:

- Personal income tax: 64%
- Corporate income tax: 16.6%
- Sales tax: 44.6%
- Gross production-Gas: 50.2%
- Gross production-Oil: None
- Motor vehicle tax: 26.1%
- Other sources: 25.8%

July GRF allocations were higher than the estimate by \$23.2 million or 5.9%.

July insurance premium taxes totaled \$81,000, a decrease of \$1.49 million, or 94.9%, from the prior year.

Tribal gaming fees generated \$10.48 million during the month, up by \$228,000, or 2.2%, from last July.

## Gross Receipts to the Treasury drop at start of new fiscal year

Gross Receipts to the Treasury in July fell 5 percent below collections from the same month of the prior year. This is the third consecutive month and the fourth time in five months the year-over-year comparison has been negative, State Treasurer Ken Miller announced today.

Lower collections from taxes on income and on the production of oil and natural gas provided the downward push in July. Combined personal and corporate income taxes shrank by 5.4 percent, while gross production taxes fell by almost 47 percent.

“The impact of low oil prices continues to make itself known in monthly Gross Receipts to the Treasury,” Miller said. “The resulting increase

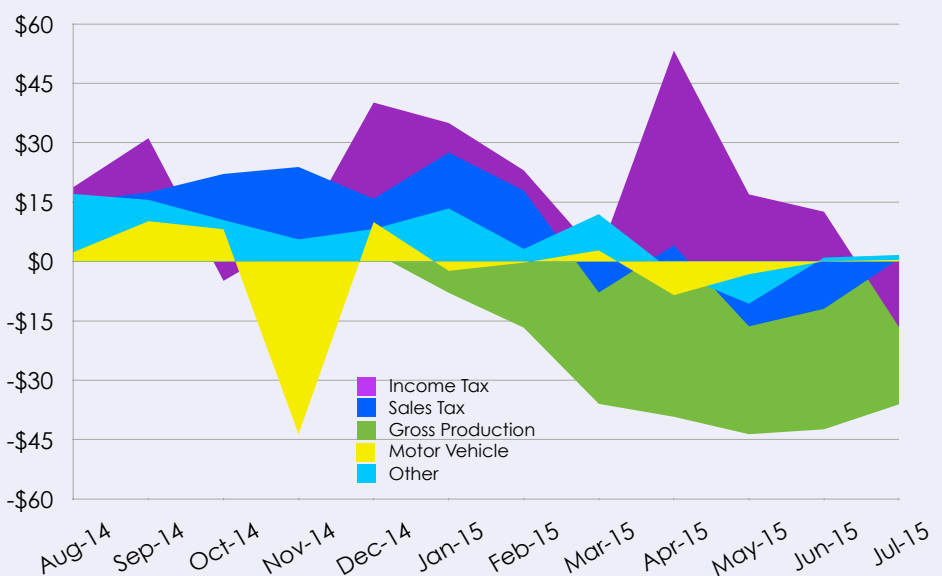
in unemployment is also something of a factor this month with withholding taxes down by more than 6 percent from the prior year – accounting for the entire drop in personal income tax collections.”

July gross production collections are from oilfield activity in May, when West Texas Intermediate crude oil was selling for about \$60 per barrel in Cushing. Oil prices fell to less than \$45 in late January, rebounded

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“The impact of low oil prices continues to make itself known in monthly Gross Receipts to the Treasury.”

### Monthly Gross Receipts vs. Prior Year



Dollar change (in millions) from prior year

Source: Office of the State Treasurer



## Revenue

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slightly and are now at less than \$50.

Sales tax and motor vehicle tax collections both showed slight growth in July – up by 0.2 percent and 0.6 percent, respectively.

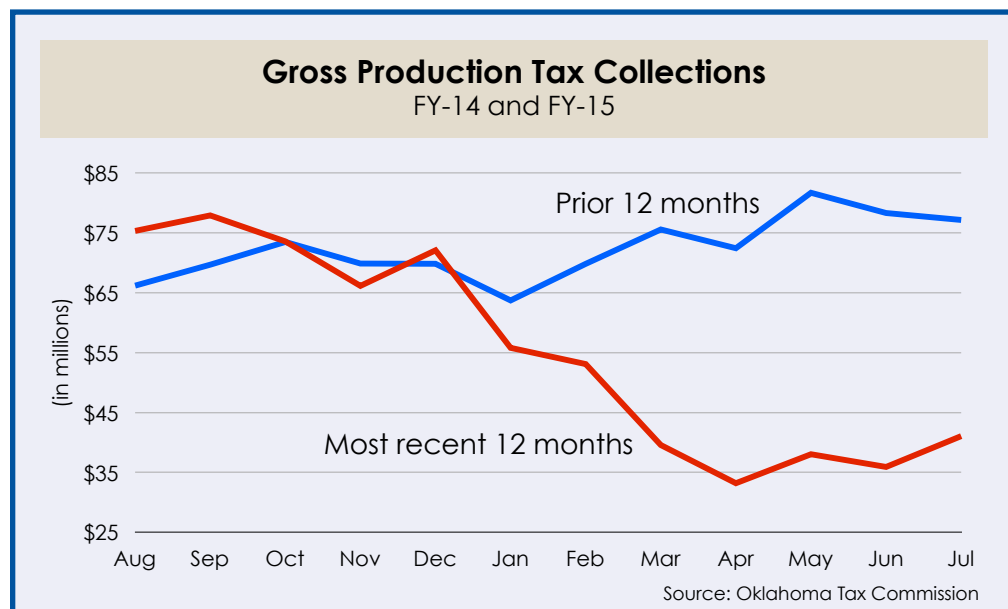
Gross receipts for the past 12 months total \$11.93 billion, with a growth rate of 1.4 percent compared to the prior 12 months. While the rate of growth in 12-month collections has

remained positive for almost five years, the current rate is the lowest since November 2010.

In the past 12 months, gross production tax collections are down by almost 24 percent and motor vehicle collections are off by more than 3 percent. Remaining growth positive over the 12 months are income tax collections, at 5.2 percent, and sales tax collections, at 2.5 percent.

### About Gross Receipts to the Treasury

Since March 2011, the Treasurer's Office has issued the monthly Gross Receipts to the Treasury report, which provides a timely and broad view of the state's macro economy. It is provided in conjunction with the General Revenue Fund allocation report from the Office of Management and Enterprise Services.



## Oklahoma jobless rate holds steady in July at 4.5 percent

Oklahoma's seasonally-adjusted unemployment rate remained at 4.5 percent in July, according to the Oklahoma Employment Security Commission.

The number of those listed as unemployed rose by 826 from June, and was up by 5,449 from last July, when the jobless rate was set at 4.4 percent. The Mining and Logging supersector, which includes the energy sector, is now down 9,100 jobs from the recent high set last November.

The national unemployment rate was set at 5.3 percent in July.

Oklahoma Unemployment Report				
OKLAHOMA	Unemp. rate*	Labor force*	Employment*	Unemployment*
July '15	4.5%	1,853,583	1,769,720	83,863
June '15	4.5%	1,862,461	1,779,424	83,037
May '15	4.3%	1,863,285	1,783,101	80,184
April '15	4.1%	1,851,003	1,775,355	75,648
March '15	3.9%	1,832,611	1,761,551	71,060
Feb '15	3.9%	1,812,701	1,742,496	70,205
July '14	4.4%	1,777,612	1,699,198	78,414

\* Data adjusted for seasonal factors

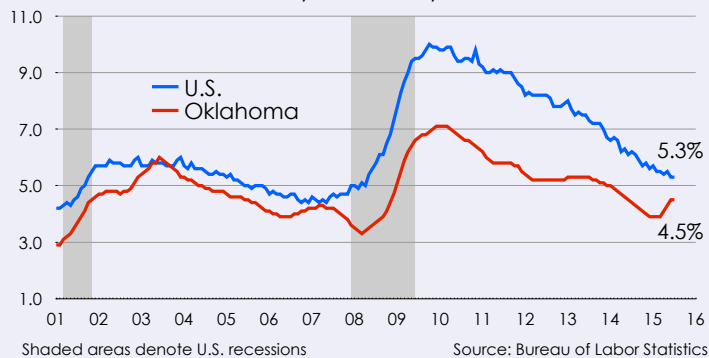
Source: OESC



## Economic Indicators

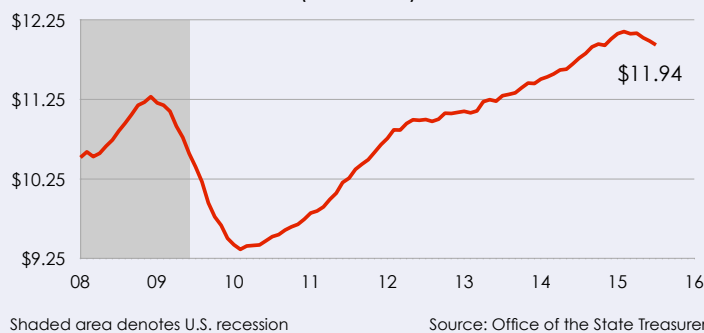
### Unemployment Rate

January 2001 – July 2015



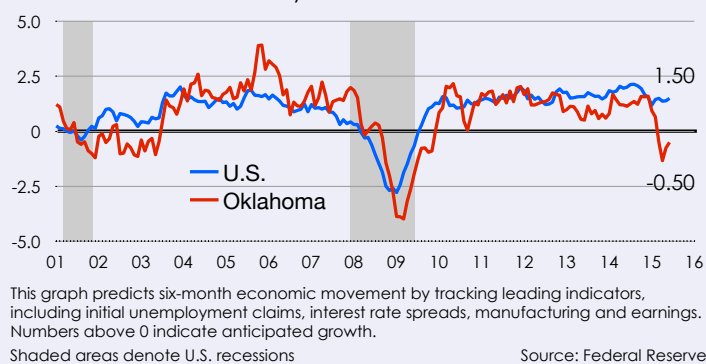
### Oklahoma 12-Month Gross Receipts

January 2008 – July 2015  
(in billions)



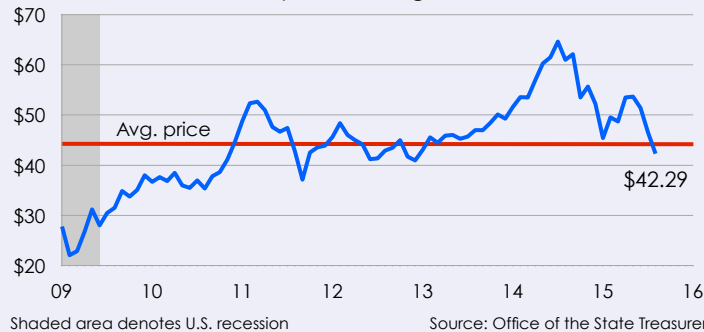
### Leading Economic Index

January 2001 – June 2015



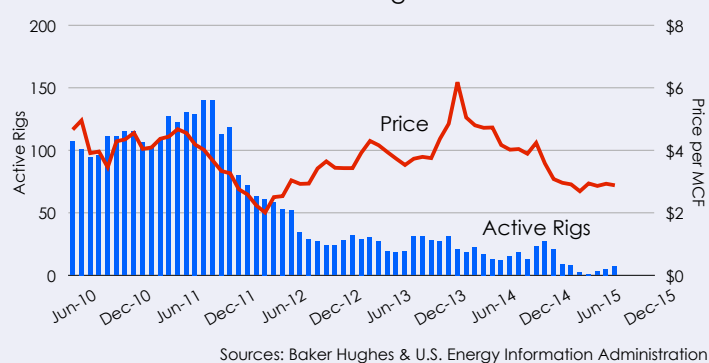
### Oklahoma Stock Index

Top 23 capitalized companies  
January 2009 – August 2015



### Oklahoma Natural Gas Prices & Active Rigs

June 2010 – August 2015



### Oklahoma Oil Prices & Active Rigs

June 2010 – August 2015

